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SUBJECT: COMMERCE U/S LAVIN MEETS NDRC VICE CHAIRMAN ZHANG,
SASAC VICE CHAIRMAN SHAO

¶1. (SBU)Summary: Franklin L. Lavin, Department of Commerce Under Secretary (U/S) for International Trade on July 28, 2006 held separate meetings with National Development and Reform Commission (NDRC) Vice Chairman Zhang Xiaoqiang and State-owned Asset Supervisory and Administration Commission (SASAC) Vice Chairman Shao Ning. U/S Lavin during his meeting with NDRC Vice Chairman Zhang stated there is a growing perception that China is allowing political considerations to influence its economic policy. He said a recent joint letter from Commerce Secretary Gutierrez and Energy Secretary Bodman demonstrates Washingon's support for Westinghouse's bid in China's nuclear power plant competition. NDRC Vice Chairman Zhang said the Chinese Government is enacting policies that reflect the changing nature of China's market rather than being protectionist. He stated Beijing appreciated the Westinghouse letter's significance, but reiterated the long-term support of the competing companies host governments is a key criteria in the competition. U/S Lavin closed by inviting NDRC participation in a venture capital forum, while Vice Chairman Zhang closed by encouraging Washington participation in energy talks to be held in Beijing.

¶2. (SBU) During his meeting with SASAC Vice Chairman Shao, U/S Lavin stated that it is important for Washington to learn as much as possible about how China's SOE system operates. He said there is a need for China's stated owed enterprises (SOEs) to make dividend payments to the Chinese Government, rather than simply plow profits back into the enterprise. This would level the playing field between the SOEs and foreign companies doing business in the China. SASAC Vice Chairman Shao said he agreed with this point. He stated that the Chinese Government is working to establish a system that would facilitate such payments. The system also will allow SASAC to better manage the sell-off or spin-off of subsidiaries from SOEs. End Summary.

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Under Secretary Lavin Meets With NDRC Vice Chairman Zhang
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Zhang Defends Recent Foreign Investment Restrictions

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¶3. (SBU) U/S Lavin, accompanied by Clark T. Randt, U.S. Ambassador to China, on July 28, 2006 met NDRC Vice Chairman Zhang Xiaoqiang to discuss a broad range of bilateral trade and investment issues. U/S Lavin started the meeting by stating that some in the United States perceive that the Chinese Government is increasingly allowing political issues to influence investment decisions in China. Vice Chairman Zhang said that Beijing, since the beginning of its opening and reform period, has sought to promote the introduction of advanced management techniques, high-technology, and foreign capital into the Chinese market. Beijing's evolving economic policies must reflect the changing nature of investment activity in China while also protecting the environment and promoting energy efficiency.

¶4. (SBU) Vice Chairman Zhang said that in previous years mergers and acquisitions (M&A) accounted for about five percent of foreign direct investment (FDI) in China. M&A activities in 2005 accounted for 20 percent of China's FDI. Vice Chairman Zhang stated many Chinese government and industry observers have commented that if left unchecked, this trend could damage China's economic security. To avoid this type of damage, the NDRC is placing restrictions on foreign investment in the financial, energy, and heavy machinery equipment sectors. Vice Chairman Zhang said that the Chinese Government has closely studied the U.S. Government's response to 9/11. Beijing has noted that following 9/11 Washington placed restrictions on foreign investment in several sectors, including agriculture, energy, transportation, banking and finance, and high-technology. The Chinese Government similarly believes it is important to protect its economy from foreign threats.



¶5. (SBU) U/S Lavin stated Washington understands Beijing must ensure that it protects China's economic security when formulating investment policies. In some recent cases, however, it appears Beijing is protecting domestic businesses rather than the country's economic security. The steel and automobile sectors in particular, are growing areas of concern in that regard. U/S Lavin noted that cross border investment can help countries avoid bilateral trade frictions, such as antidumping charges. Vice Chairman Zhang said that China's automobile and steel sectors have always been open to foreign investment. China's automobile industry has largely been built through joint ventures with the world's leading automobile manufacturers, including General Motors, Volkswagen, and Nissan among others. China only has one brand of automobile that is not foreign. Vice Chairman Zhang said that foreign interest in participating in China's steel sector is relatively recent since the sector has expanded only in the past several years to the degree necessary to attract foreign investment. Arcelor and Mittal, two of the world's leading steel makers, now have significant investment in Chinese steel enterprises. U/S Lavin said that Beijing's achievement ensuring foreign investment in these sectors is laudable, and certainly contributed to the past twenty years of China's economic growth. The concern among many U.S. investors and businesses is that the appearance of a growing economic nationalism in China may prevent similar success stories during the next twenty years.

Zhang, Lavin Discuss Westinghouse, JCCT Commitments
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¶6. (SBU) U/S Lavin said that he wanted to ensure that Beijing understands the significance of a recent joint letter from Commerce Secretary Gutierrez and Energy Secretary Bodman to the Chinese Government supporting

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Westinghouse's bid to build nuclear power plants in China.

This type of joint letter is rare and should be taken as a signal of the U.S. Government's firm commitment to Westinghouse. Vice Chairman Zhang stated that the Chinese Government took note of the positive attitude of the U.S. Government towards Westinghouse's bid. Beijing believes that the company selected to participate in China's nuclear power program needs to have the firm backing of its government.

¶7. (SBU) Vice Chairman Zhang said he is aware that in the past some contracts between U.S. companies and Chinese counterparts have been nullified because of political factors. In many cases, Beijing has been willing to accept these decisions because the contracts were relatively small. Zhang said that in the case of the nuclear power program, however, anything short of a full, long-term commitment by the U.S. Government would be unacceptable. U/S Lavin stated that Washington wants to ensure that Westinghouse is able to compete for the contract on normal business terms. Beyond the joint letter, the U.S. Government's long-term commitment to peaceful nuclear power programs abroad has been futher demonstrated by the recent passing of Congressional legislation supporting U.S. participation in India's nuclear power program.

¶8. (SBU) U/S Lavin stated that the U.S. Government appreciates the efforts the NDRC has taken to date in communicating with U.S. medical device companies. Company representatives indicate that solid groundwork has been laid for future cooperation. U/S Lavin said that the U.S. Government is pleased that the Chinese Government continues to take positive steps following the recent Joint Commission on Commerce and Trade (JCCT) talks in Washington to enable express delivery services to expand their business in China. The development of these businesses in China will inevitably expand the country's economic growth. U/S Lavin stated that Washington also has been pleased with Beijing's neutral stance on the type of 3G cell phone technology to be used in



China. Vice Chairman Zhang said Beijing remains committed to enacting postal reform that promotes a healthy business climate for express delivery services and other related businesses. Beijing will allow the market to determine the best 3G cell phone technology for Chinese customers. Vice Chairman Zhang stated for a particular cell phone technology to be successful in China, it will need to be advanced and reliable, provide good return on investment for the companies employing it, and will have to adhere to China's information security laws.

## Zhang Presses For More U.S. Hi-Tech Exports

¶9. (SBU) Vice Chairman Zhang stated one of the most important discussions held during the recent JCCT dialog was that regarding the need to increase U.S. exports to China. As stated during the JCCT, Beijing believes the lifting of U.S. export restrictions on high technology (hi-tech) civil use computer equipment and components is the most immediate way to increase U.S. exports. The Chinese Government estimates it would lead to a 20 billion U.S. dollar annual increase in U.S. exports to China. Vice Chairman Zhang stated Beijing has learned that Washington is considering amending its export regulations to make them more restrictive. U/S Lavin stated that he questioned whether the lifting of export restrictions on hi-tech sales would have as significant an impact as Beijing suspects. It also is important to note that the United States is a leading exporter to China of other items, such as cotton and soybeans. Additionally, during the first five months of 2006, overall U.S. exports to China have grown by some 36.5 percent. U/S Lavin stated these facts point to the improving competitiveness of U.S. products in the Chinese market.

¶10. (SBU) Vice Chairman Zhang said despite rising U.S. exports to China during the first part of 2006, the Chinese Government still maintains U.S. companies are missing out on hi-tech opportunities in China. Chinese Government statistics indicate that in 2005, foreign businesses exported some 200 billion U.S. dollars worth of hi-tech products to China. The United States accounted for only around six percent of this trade. Vice Chairman Zhang stated that U.S. companies could capture the bulk of this trade if Washington would ease export restrictions. U.S. trade success in other areas, such as agricultural products, is laudable, but pale in comparison to the potential of the hi-tech field. U/S Lavin stated that several U.S. hi-tech products could be exported to China if provided adequate market access. These products include clean coal technology developed by General Electric and fiber optic cable made by Corning. U/S Lavin stated that if the Chinese Government and Chinese businesses want to have a voice in the U.S. export regime, they should provide written comments on the pending revised export regulations. These regulations are currently in a public comment period, but to date, Beijing has not participated in the process. Vice Chairman Zhang said that he would encourage the Chinese Government and Chinese businesses to participate in the proposed export regulation comment process.

Zhang Promotes Energy Talks, Lavin Venture Capital Forum
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¶11. (SBU) Vice Chairman Zhang stated the Chinese Government hopes to build upon the rapport established by Chinese President Hu and U.S. President Bush during their meetings in Washington and on the margins of the G8 in Moscow. The recent strengthening of bilateral political and economic ties is a positive development for the people of both countries. To that end, Vice Chairman Zhang closed by encouraging U.S. participation in a Five Party Energy Ministerial dialog proposed by Beijing. U/S Lavin said that he appreciated the opportunity to meet with Vice Chairman Zhang and other senior Chinese economic and trade



policymakers. He said the Department of Commerce would like to extend a formal invitation to the NDRC to attend a venture capital forum to be held in the United States. The forum will be similar to one hosted by the NDRC several years ago. U/S Lavin closed his remarks by stating that he hoped that the NDRC would accept the invitation and that Vice Chairman Zhang would lead the Chinese delegation to the forum.

¶12. (U) Chinese Participants:

-NDRC Vice Chairman Zhang
-Chen Bin, Vice Director, Department of Industry, NDRC
-Li Bin, Deputy Director General, Department of Foreign Affairs, NDRC
-Wang Dong, Deputy Director General, Department of Foreign Capital Utilization, NDRC
-Zhou Wangjun, Deputy Director General, Department of Prices, NDRC

¶13. (U) United States Participants:

-Franklin L. Lavin, Under Secretary of Commerce for International Trade
-Clark T. Randt, United States Ambassador to China
-Cheryl McQueen, Director, Office of the Chinese Economic Area, Market Access & Compliance
-Matthew Dauphinais, Special Assistant, Office of the Under Secretary of Commerce for International Trade

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-Barry I. Friedman, Senior Commercial Officer, U.S. Embassy Beijing
-Robert S. Luke, Economic Minister Counselor, U.S. Embassy

Beijing

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Under Secretary Lavin Meets With SASAC Vice Chairman Shao
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Shao Provides SOE Reform History, Explains SASAC's Role
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¶14. (SBU) On July 28, 2006 U/S Lavin met with SASAC Vice Chairman Shao Ning to discuss the Chinese Government's progress in reforming its SOE system. Vice Chairman Shao began his comments by stating that SASAC has only been a government office since 2003 and is in the early stages of its work. The most significant achievement to date in SOE reform occurred in 1998 when Beijing severed the financial tether binding the Central Government, Chinese state-owned banks, and SOEs. This resulted in a large number of SOEs going bankrupt because they were no longer guaranteed bank loans to cover operating losses, but it ensured the financial viability of those SOEs that survived. Vice Chairman Shao said that the next stage of reform would result in further closure or sale of numerous large SOEs. This should leave each Chinese Province retaining only 10 to 20 of its large SOEs while the Central Government should be left with less than 100, down from its current portfolio of
¶169.

¶15. (SBU) U/S Lavin said that it is very important for the U.S. Government to learn as much as possible about how China's SOE system operates given the close economic ties between the two countries. In particular, it would be helpful to know the scale of Central SOE's that SASAC oversees and SASAC's management role in these enterprises. Vice Chairman Shao stated that the State Grid Company with some 1.3 million employees is the largest SOE in SASAC's portfolio. Meanwhile, two energy SOEs, Sinopec and PetroChina, are the leaders in terms of revenue and profit. Vice Chairman Shao said that SASAC's role in managing its SOEs is best illustrated by using PetroChina as an example. SASAC has no role in PetroChina's decisions where to drill for oil or natural gas. That type of decision is left to PetroChina's professional managers. By contrast, if PetroChina decided that it wanted to go into the real estate



or other non-core business areas, the enterprise must have SASAC's approval.

Shao Admits Approving Non-Core Business Ventures
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¶16. (SBU) U/S Lavin said that Vice Chairman Shao's explanation of SASAC's role in managing its SOEs raises a question regarding Baosteel's role in the competition to purchase the Guangdong Development Bank. Baosteel has teamed with French Bank, Societe Generale (SocGen), in that competition. SocGen has little experience operating in China and small financial resources compared to its U.S. competitor, Citibank. U/S Lavin stated that this fact, coupled with Baosteel's previous lack of financial sector experience, is leading some to suggest Baosteel's role is merely to lend its strong ties to the Chinese Government to a company too weak to win on its own merits. Otherwise, it is unclear why Baosteel would launch a foray into a field that is clearly divorced from its core business interests. Vice Chairman Shao stated that SASAC approved Baosteel's request to participate in the Guangdong Development Bank competition. Baosteel presented its case to SASAC as one of wanting to invest on-hand cash reserves rathe than that of evolving into a financial services or banking enterprise. Baosteel stated that margins in the steel sector are currently so tight that further investment in steelmaking would be unprofitable, but investing in the banking sector provided opportunity for significant returns.

Shao Supports Siphoning SOE Dividend PaymentsTo Beijing
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¶17. (SBU) U/S Lavin stated that this situation pointed to the need of SOEs to return some of their profits back to their shareholders, most notably the Chinese Government, rather than simply plow them back into the enterprise. In the United States and other countries this is one of the ways shareholders earn a return on their investment in a company. This type of system also would serve the purpose of leveling the playing field between China's SOEs and foreign companies trying to do business in the Chinese market. Vice Chairman Shao said that he agreed with this assessment. Dividend payment is one of the next steps in SOE reform, but SASAC first must develop a mechanism to facilitate these transactions. To this end, SASAC is working to establish a state asset operation budget system. Vice Chairman Shao said that this system would create a means for SOEs to make dividend payments to the Chinese Government. The new budget system also would enable SASAC to have more flexibility in managing the sell-off or spin-off of subsidiaries from SOEs. U/S Lavin closed by encouraging SASAC to remain in close contact with U.S. Embassy Beijing as it develops this system. For his part, Vice Chairman Shao closed by welcoming further interaction with U.S. Government and U.S. business officials because SASAC is solicitous of international comments on China's SOE reform process.

¶18. (U) Chinese participants:

-SASAC Vice Chairman Shao Ning
-Zhang Zhonglin, Deputy Director General, Bureau of Planning and Development, SASAC
- Yan Xiaofeng, Director General, Bureau of Foreign Affairs, SASAC

¶19. (U) United States participants:

-Franklin L. Lavin, Under Secretary of Commerce for International Trade
-Cheryl McQueen, Director, Office of the Chinese Economic Area, Market Access & Compliance
-Matthew Dauphinais, Special Assistant, Office of the Under Secretary of Commerce for International Trade

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-Barry I. Friedman, Senior Commercial Officer, U.S. Embassy



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¶20. (U) U/S Lavin cleared this cable prior to departing Beijing.

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